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Thank you for the invitation to join you to discuss revisions to §125 of the Internal Revenue Code as it relates to small business owners. My name is Jennifer Brown and I am the Manager of Research at the National Institute on Retirement Security (NIRS). NIRS is a non-profit research and education organization which was established to inform policymaking by demonstrating the importance of retirement security to employers, employees, and American economic performance. In addition, I am also a Tax Policy Fellow at the American University's Kogod School of Business, where I conduct non-partisan research on tax and compliance issues specific to small businesses and entrepreneurs. Prior to my appointment at Kogod and at NIRS, I was an Employee Benefits Law Specialist for the U.S. Department of Labor's Employee Benefits Security Administration, where I worked on retirement, welfare, and health plans. In addition to my federal government service, I was also an ERISA Legislative History Research Assistant at the Georgetown University Law Center.

Overview of §125 "Cafeteria" Plans

Section 125 of the Internal Revenue Code ("Code") regulates "Cafeteria Plans," which are tax-favored methods for offering a variety of fringe benefits to employees on a pre-tax basis through a plan offered by an employer. They are called cafeteria plans because these plans give an employees the ability to select benefits from a menu set by their employer, in exchange for forgoing compensation. Some cafeteria plans offer a choice between cash and one or more type of insurance coverage, while other plans offer one or more reimbursement accounts.[1] The fringe benefits that can be offered through such plans are:

1) Accidental death and dismemberment insurance policy (§106);
2) Accident and health benefits (§§105-106);

[1] David Ralsh, *Cafeteria Plans*, 397 TAX MGMT. PORT. (BNA) B-4 (2017).

3) Adoption assistance benefits (§137);
4) COBRA continuation coverage; (§106)
5) Death and dismemberment insurance;
6) Dependent care assistance (§129);
7) Flexible Spending Arrangements (FSAs);
8) Group term life insurance (§79);
9) Health Savings Accounts (HSA's) (§223 and §125(d)(2)(D); and
10) Long-term and short-term disability coverage (§106).[2]

Additionally, an employer can offer coverage under a 401(k) cash or deferred arrangement in a cafeteria plan.[3]

Non-Discrimination Tests

Similar to other types of employee benefit plans, such as 401(k) plans, cafeteria plans must meet separate non-discrimination requirements, which were created in order to prevent benefits that are exclusively offered to "highly compensated" participants and not to "rank and file" employees. These rules are echoed by many other places in the Code in regards to employee benefit plans. But, §125 contains an additional non-discrimination rule which limits non-taxable benefits to "key employees" to 25% of all benefits.

These non-discrimination tests can be complicated, but they boil down to three basic themes:

1) Eligibility – if too many rank and file employees are excluded from participation in the plan, the plan will be discriminatory;[4]
2) Availability of Benefits- the plan will not pass the non-discrimination tests if the highly compensated participants or key employees can access more benefits or the benefits they can access are more valuable than the benefits of rank-and-file employees;[5]
3) Utilization – a plan will not pass the non-discrimination tests if the highly compensated participants or key employees actually elect more benefits under the plan than rank-and-file employees.[6]

If a cafeteria plan fails these tests, the participants of the plan must include these otherwise tax-free benefits in their taxable income.

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[2] I.R.C. § 125 (2006).
[3] I.R.C. §§ 125(d)(1)(B), (f) (2006).
[4] I.R.C. § 125(b)(1)(A) (2006).
[5] I.R.C. § 125(b)(1)(B) (2006).
[6] Prop. Reg. §1.125-1, §1.125-2, §1.125-5, §1.125-6 and §1.125-7, 72 Fed. Reg. 43938 (Aug. 6, 2007).

Highly Compensated Participants and Key Employees Defined

Section 125 contains separate definitions for highly compensated participants and also key employees. Highly compensated participants are defined in §125(e)(1) as a participant who is:

a) an officer;
b) a shareholder owning more than five percent of the voting power or value of all classes of stock of the employer;
c) highly compensated, or
d) is a spouse or a dependent of an individual mentioned above.

Similarly, §125 defines a key employee, in reference to §416(i)(1), and includes:

a) an officer of the employer who has an annual compensation greater than $130,000;
b) a five percent owner of the employer; or
c) a one percent owner of the employer who receives an annual compensation of more than $150,000.[7]

Self-Employed Individuals, Partners in a Partnership and S-Corp. Shareholders

Self-employed individuals, partners in a partnership, and 2% shareholders of an S-Corporation are excluded from participating in §125 cafeteria plans, but are still able to sponsor plans for their employees.[8] This is unlike §401(c), where self-employed individuals can participate in pension, profit-sharing and stock bonus plans along-side their employees.[9] And in §129, where these individuals can also participate in dependent care assistance programs.[10]

Legislative History

Provisions excluding highly compensated individuals from tax-sheltered retirement plans have been in place since 1942, after employers sought to provide tax-sheltered retirement benefits to "key employees," including officers, shareholders, and highly compensated employees.[11] These "key man trusts" were first introduced in 1936 and were legislatively prohibited in the 1942 Revenue Act.[12]

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[7] I.R.C. § 416(i)(1) (2006).
[8] Prop. Reg. §1.125-1, §1.125-2, §1.125-5, §1.125-6 and §1.125-7 (hereinafter "2007 proposed regulations" or "2007 Prop. Reg."), REG-142695-05, 72 Fed. Reg. 43938 (8/6/07).
[9] I.R.C. § 401(c) (2006).
[10] I.R.C. § 129 (2006).
[11] James Wooten, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 – A POLITICAL HISTORY, 31-32 (2004).
[12] Revenue Act of 1942, § 127(a), Pub. L. No. 753, 56 Stat. 798, 825, codified as Internal Revenue Code of 1939, §23(x).

The same prohibitions against highly compensated individuals participating in tax-sheltered retirement plans did not extend to the payment of employee health insurance premiums.[13] Between 1936 and 1978, many corporations adopted plans that reimbursed the medical expenses of shareholders and officers, but not those of rank-and-file employees.[14] Treasury became very concerned with these "particularly abusive situations," and singled out four closely held corporations which reimbursed the medical expenses of shareholder-officers as a "way to disguise [otherwise taxable] dividends."[15]

This fear pervaded Treasury's actions through 2007. In the introduction of the cafeteria plan legislation, the Treasury proposed stricter anti-discrimination rules – specifically in regards to highly compensated individuals.[16] Treasury feared that, without stricter anti-discrimination rules in a cafeteria plan, higher paid employees would select non-taxable health benefits, while lower-paid employees would select taxable cash payments.[17] To prevent this, Treasury's rules were designed to ensure that lower-paid employees actually used the available non-taxable benefits.[18] But, Congress did not seem to echo Treasury's fears in the Revenue Act of 1978 – as §125 was enacted with only the provision that "a cafeteria plan does not discriminate where nontaxable benefits and total benefits do not discriminate in favor of highly compensated participants."[19] Yet the legislation left the door open for Treasury to "prescribe such regulations as may be necessary to carry out the provisions of this section."[20]

But, during the time period between 1978 to 1983, Treasury did not issue any regulations regarding non-discrimination in §125 plans.[21] Thus, employers were left with the statutory language from Congress as guidance regarding these plans. After Treasury issued a set of proposed regulations in 1984 in the form of questions and answers,[22] Congress, as part of the Tax Reform Act of 1984

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[13] Daniel Schaffer & Daniel Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 AM. J. TAX POL'Y 1, 6 (1989).
[14] *Id.*
[15] *Id.* (citing Department of the Treasury, The President's 1978 Tax Program: Detailed Descriptions and Supporting Analysis of the Proposals 145 (January 30, 1978), reprinted in The Presidents 1978 Tax Reduction and Reform Proposals: Hearings Before the House Committee on Ways and Means, 95th Cong., 2d Sess. 160, 304 (1978)).
[16] Daniel Schaffer & Daniel Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 AM. J. TAX POL'Y 1, 14 (1989).
[17] *Id.*
[18] *Id.*
[19] Revenue Act of 1978, Pub. L. No 95-600, § 134(a), 92 Stat. 2763, 2783, codified as Internal Revenue Code of 1954, § 125.
[20] Revenue Act of 1978, Pub. L. No 95-600, § 134(a), 92 Stat. 2763, 2783, codified as Internal Revenue Code of 1954, § 125.
[21] *See* Daniel Schaffer & Daniel Fox, *Tax Law as Health Policy: A History of Cafeteria Plans 1978-1985*, 8 AM. J. TAX POL'Y 1, 31-37 (1989).
[22] 49 Fed. Reg. 19321 (May 7, 1984).

("TRA") addressed some of Treasury's concerns regarding cafeteria plan non-discrimination issues by adding additional language defining key employees and the benefits that can be received by these employees.[23] The TRA prohibited plans that favored the highest paid officers and owners – key employees – especially those that received more than 25% of the total benefits provided by the plan.[24] This addition of the key employee provision in the TRA disproportionately affected the ability of small firms to offer cafeteria plans. In a large firm, a key employee could still be offered significant benefits through a cafeteria plan without exceeding the 25% threshold. On the other hand, in a small firm, even limited benefits provided to a key employee could quickly exceed the 25% threshold.[25]

Then, in 2007 the Internal Revenue Service issued proposed regulations which finally enacted a test that ensured that lower-paid employees actually used the available non-taxable benefits.[26] Specifically, the 2007 proposed regulations provide that:

> a cafeteria plan does not discriminate with respect to contributions and benefits if either qualified benefits and total benefits, or employer contributions allocable to statutory nontaxable benefits and employer contributions allocable to total benefits, do not discriminate in favor of highly compensated participants. A cafeteria plan must satisfy this paragraph . . . with respect to both benefit availability and **benefit utilization**. **Thus, a plan must give each similarly situated participant a uniform opportunity to elect qualified benefits, and the actual election of qualified benefits through the plan must not be disproportionate by highly compensated participants (while other participants elect permitted taxable benefits).**[27]

Later, in 2010, as part of the Patient Protection and Affordable Care Act (the "PPACA" or the "ACA"), Congress relaxed the nondiscrimination requirements for §125 Cafeteria plans for small employers with under 100 employees.[28] Specifically, the ACA provided for "simple cafeteria plans" which provided employers a safe harbor from the nondiscrimination requirements of cafeteria plans and any nondiscrimination requirements for any of the benefits provided under a cafeteria plan.

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[23] Tax Reform Act of 1984, Pub. L. No. 98-369, § 53, 98 Stat. 494, codified as Internal Revenue Code of 1954, § 125.
[24] Tax Reform Act of 1984, Pub. L. No. 98-369, § 53(b)(2), 98 Stat. 494, codified as Internal Revenue Code of 1954, § 125(b)(2).
[25] See, e.g., Testimony of Hon. Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration, Hearing on the Small Business Retirement and Benefit Extension Act S. 1426, October 23, 1987 (https://www.finance.senate.gov/imo/media/doc/hrg100-518.pdf).
[26] Prop. Reg. §1.125-7, 72 Fed. Reg. 43938 (Aug. 6, 2007).
[27] Prop. Reg. §1.125-7, 72 Fed. Reg. 43938 (Aug. 6, 2007) (emphasis added).
[28] Pub. L. No 111-148.

Conclusion

Since 1978, Treasury and Congress have focused on preventing the abuse of cafeteria plans by owners of closely held corporations due to fears from particular abuses by corporations in 1978. Congress has provided small employers with relaxed nondiscrimination requirements in simple cafeteria plans through the ACA in 2010. However, self-employed individuals, partners in a partnership, and 2% shareholders of an S-Corporation may only sponsor these cafeteria plans today, but cannot participate in these plans alongside their employees.